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Treatment of Emission Reduction Credits in Bankruptcy

Tilda Chof

In recent years, 'pollution credit' trading¹ has generated much controversy. At first glance, it may seem that these programs demonstrate that the government condones or even encourages pollution. In reality, this type of trading allows Congress and government agencies to promulgate rules that will decrease overall pollution emissions at a lower cost than with more traditional reduction programs.²

Because trading in pollution credits is a new concept, legal commentators and the courts have not yet addressed its relationship to other areas of the law. To that end, this Comment addresses the relationship between pollution trading programs and bankruptcy law. Legal commentators and the judiciary have heretofore ignored the imminent problem of the bankrupt debtor holding pollution credits.

The treatment of pollution credits in the context of a bankruptcy proceeding affects the Environmental Protection Agency ("EPA"), Congress, creditors, the judiciary, and utility company participants. The EPA and Congress have an interest in the treatment of pollution credits in bankruptcy because it may bear on the regulatory effectiveness of the trading programs. Creditors require accurate information about the assets of a company in order to assess its creditworthiness. Judges need to know how to treat and value emissions credits in bankruptcy proceedings before them. Finally, utilities need to better understand the ramifications of their behavior in using, selling, and buying these credits. This Comment suggests an approach to the treatment of these credits in bankruptcy.

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¹ Pollution credit trading entails an initial allocation of credits, which correspond to a particular level of pollution, and allows entities to pollute more or less than allocated, buying or selling excess credits. See discussion at Parts I.A and I.B.

² Major Vincent Joseph Rafferty, Jr., *Uncle Sam Goes to Market: Federal Agency Disposal of Emissions Reduction Credits under the Federal Property Management Regulations*, 146 Milit L Rev 154, 167-68 (1994).

Part I.A discusses Congress's first attempt at emissions trading legislation. Part I.B describes the 1990 Clean Air Act Amendments that created the federal sulfur dioxide ("SO₂") trading program to lower the incidence of acid rain. Part II.A explains the provisions of the Bankruptcy Code that determine the inclusion or exclusion of the debtor's assets in the bankruptcy estate and the impact that insolvency has on the trustee's powers. Part II.B shows that no courts or commentators to date appear to have addressed the treatment of pollution credits in the bankruptcy context. Part III.A argues that the bankruptcy estate should include the debtor's unused emission reduction credits. Finally, Part III.B analyzes the different methodologies available to value these credits and concludes that fair market value is most consistent with the Bankruptcy Code.

I. EMISSIONS TRADING PROGRAMS

The treatment of excess credits created by pollution trading programs in the bankruptcy context is an unresolved question. The Clean Air Act ("CAA")³ and the Bankruptcy Code ("Code")⁴ are the primary statutes that must be considered in formulating an approach to the treatment of emissions credits in bankruptcy. Congress passed its first air pollution law in 1955,⁵ followed by a long series of amendments, the most recent coming in 1990.⁶ The CAA establishes national air quality standards to be implemented in large part by the states.⁷ Further, it charges the EPA with implementing the CAA's provisions.⁸ The Bankruptcy Code provides a mechanism by which debtors can discharge past liabilities and "obtain a financial fresh start."⁹ It exhibits a balance be-

³ 42 USC § 7401 et seq (1994).

⁴ 11 USC § 101 et seq (1994).

⁵ Act of July 14, 1955, 69 Stat 322, codified as amended at 42 USC § 7401 et seq (Chapter created was subsequently named the Clean Air Act. Act of Dec 17, 1963, Pub L No 88-206, 77 Stat 392, 401.).

⁶ The most notable amendments include: Clean Air Act Amendments of 1970, Pub L No 91-604, 84 Stat 1676; Clean Air Act Amendments of 1977, Pub L No 95-95, 91 Stat 685; Clean Air Act Amendments of 1990, Pub L No 101-549, 104 Stat 2399.

⁷ 42 USC § 7407-10. See also John Quarles and William H. Lewis, Jr., *The New Clean Air Act: A Guide to the Clean Air Program as Amended in 1990* 7-16 (Morgan, Lewis & Bockius, 1990) ("New Clean Air Act").

⁸ 42 USC § 7601.

⁹ Douglas G. Baird and Thomas H. Jackson, *Cases, Problems, and Materials on Bankruptcy* 37 (Little, Brown 2d ed 1990).

tween the interests of the debtor, its creditors, and the general public.¹⁰

A. Congress and the EPA's Initial Emissions Trading Programs

Since the mid-seventies, policy makers have attempted to introduce a measure of flexibility into the CAA's regulatory framework.¹¹ At the EPA, this movement culminated in 1986 with an emissions trading policy allowing for various forms of intra- and inter-firm trading.¹² In 1990, Congress continued the shift toward more flexible strategies by initiating a national sulfur dioxide ("SO₂") trading program for electric utilities, thereby creating an open market for tradeable pollution allowances.¹³

These two programs demonstrated Congress's switch from traditional 'command and control' tactics to market-based incentives to induce companies to improve air quality. The former approach set mandatory limits on pollution emissions or required specific technologies for the control of particular pollutants.¹⁴ In stark contrast, the more recent programs provide polluters with economic incentives to reduce air emissions.¹⁵ Trading results in significant savings to industry because it allows firms either to pollute and pay for that right or to reduce emissions and sell their excess credits.¹⁶ In essence, each firm has the freedom to select the most cost-effective option.¹⁷ Congress and the EPA viewed trading as a more efficient way to control and eventually reduce the level of pollution than the traditional approach.¹⁸

¹⁰ Id.

¹¹ See *Chevron, USA, Inc. v Natural Resources Defense Council*, 467 US 837, 847-59 (1984) (describing the history of the EPA 'Bubble Policy'); Robert W. Hahn and Robert N. Stavins, *Incentive-Based Environmental Regulation: A New Era from an Old Idea?*, 18 *Ecol L Q* 1, 15-16 (1991) (same). The EPA also allowed trading of lead credits during its lead phasedown. Id. at 17.

¹² EPA, Emissions Trading Policy Statement: General Principles for Creation, Banking and Use of Emission Reduction Credits, 51 Fed Reg 43814 (1986).

¹³ Clean Air Act Amendments of 1990 § 401, 104 Stat at 2584-631, codified at 42 USC §§ 7651-51o.

¹⁴ Major Vincent Joseph Rafferty, Jr., *Uncle Sam Goes to Market: Federal Agency Disposal of Emissions Reduction Credits under the Federal Property Management Regulations*, 146 *Milit L Rev* 154, 167-68 (1994).

¹⁵ Perry S. Goldscheim, *Going Mobile: Emissions Trading Gets a Boost from Mobile Source Emission Reduction Credits*, 13 *UCLA J Envir L & Pol* 225, 230-31 (1994-95).

¹⁶ Id.

¹⁷ Id.

¹⁸ 51 Fed Reg at 43814 (cited in note 12); Clean Air Act Amendments, S Rep No 101-228, 101st Cong, 2d Sess 303 (1990), reprinted in 1990 USCCAN 3684.

Under the Clean Air Act, the EPA sets air quality standards and the states implement them.¹⁹ Consequently, the EPA's emission trading policy only delineates a structure for states to follow in constructing marketable permit systems.²⁰ The EPA established the emission reduction credit ("ERC") as the unit of currency in these emissions trading programs.²¹ ERCs grant to the holder a right to emit a particular air pollutant.²² A firm can create ERCs by reducing emissions below the baseline level allowed by its permit for that source.²³

Emissions trading encompasses four uses of emissions reduction credits: in 'bubbles,' as 'offsets,' in 'netting,' and in 'banking.'²⁴ These alternatives do not alter the aggregate amount of pollution allowed by the EPA, but give states and utilities more flexibility in meeting these standards.²⁵ A bubble is an imaginary boundary placed over one or more polluting plants or other facilities.²⁶ 'Bubbles' allow one or a group of existing plants to increase the level of pollution at one source in exchange for less pollution at another source.²⁷ In essence, the entire plant's or facility's emissions, instead of those from an individual smokestack or pipe, form a single regulatory unit.²⁸ 'Offsets' allow a firm to construct a new facility or expand an existing one after securing surplus ERCs from other sources in the area to compensate for the additional pollution that will result.²⁹ 'Netting' allows a firm to modify an existing source in a manner that increases emissions after reducing emissions at another point in the same source.³⁰ Finally, 'banking' allows firms to accumulate ERCs for future use in bubble, offset, and netting transactions.³¹ Firms may also sell or transfer banked ERCs to

¹⁹ 42 USC §§ 7407-10.

²⁰ 51 Fed Reg at 43831-32 (cited in note 12).

²¹ Id.

²² Id at 43832-33.

²³ Id at 43832. See also Robert W. Hahn and Gordon L. Hester, *Where Did All the Markets Go? An Analysis of EPA's Emissions Trading Program*, 6 Yale J Reg 109, 113-14 (1989).

²⁴ 51 Fed Reg at 43830-31 (cited in note 12). See also Rafferty, 146 Milit L Rev at 156-58 (cited in note 14).

²⁵ 51 Fed Reg at 43814 (cited in note 12).

²⁶ Rafferty, 146 Milit L Rev at 156 (cited in note 14).

²⁷ 51 Fed Reg at 43830 (cited in note 12).

²⁸ Rafferty, 146 Milit L Rev at 156 (cited in note 14).

²⁹ 51 Fed Reg at 43830-31 (cited in note 12).

³⁰ Id at 43830.

³¹ Id at 43831.

other firms.³² Ultimately, however, the states retain discretion over whether and how to establish their own programs for the creation, banking, transfer, and use of ERCs.³³

B. The SO₂ Trading Program of 1990

In 1990, Congress added Title IV of the CAA to deal with the damaging effects of acid rain.³⁴ The two primary causes of acid rain are sulfur dioxide ("SO₂") and nitrogen oxides ("NO_x").³⁵ After determining that these compounds came primarily from the burning of fossil fuels by electric utilities, Congress decided to reduce significantly power plant emissions of SO₂ and NO_x.³⁶ The NO_x reduction plan involves traditional command and control tactics as the Act sets forth mandatory emissions limitations for each utility.³⁷ By contrast, the SO₂ reduction plan calls for market-based incentives to induce utilities to comply with the EPA's regulations.³⁸ Reduction of SO₂ is to take place in two phases, the first starting January 1, 1995 and the second starting January 1, 2000.³⁹

During Phase I, the CAA allocated emissions allowances to the 110 dirtiest and largest existing utilities ('affected units')⁴⁰ and recast the allowances as commodities, available for purchase and sale.⁴¹ The initial allocations depended largely on each utility's level of emissions from 1985 to 1987.⁴² The number of emissions allowances granted corresponds to an annual emissions level that is 50% of the 1980 level.⁴³ Attaining this objective will require utilities to reduce their aggregate emissions of SO₂ by ten million tons annually by the year 2000.⁴⁴ Congress did not sub-

³² Id.

³³ 51 Fed Reg at 43831 (cited in note 12). See also Rafferty, 146 Milit L Rev at 155 (cited in note 14).

³⁴ Clean Air Act Amendments of 1990 § 401, 104 Stat at 2584-634, codified at 42 USC §§ 7651-51o.

³⁵ Larry B. Parker, Robert D. Poling and John L. Moore, *Clean Air Act Allowance Trading*, 21 Envir L 2021, 2022 (1991).

³⁶ Clean Air Act Amendments of 1990 § 401, 104 Stat at 2584-85, codified at 42 USC § 7651.

³⁷ Id at 2613-15, codified at 42 USC § 7651f.

³⁸ Id at 2589-92, codified at 42 USC § 7651b.

³⁹ Id at 2592-613, codified at 42 USC §§ 7651c, 7651d. See Quarles and Lewis, *New Clean Air Act* at 40-41 (cited in note 7).

⁴⁰ 42 USC § 7651c.

⁴¹ 42 USC § 7651b.

⁴² 42 USC § 7651c(a).

⁴³ 42 USC § 7651.

⁴⁴ Id.

ject unaffected and newly erected units to the Phase I allowance provisions, but did subject them to the Phase II provisions.⁴⁵

Phase II of the program will affect many more SO₂-emitting utilities because the definition of 'affected unit' will then expand to include smaller utilities.⁴⁶ During this phase, the number of allowances allocated will correspond to total annual emissions of 8.9 million tons of SO₂.⁴⁷

The EPA delegated the administration of annual auctions of these SO₂ allowances to the Chicago Board of Trade ("CBOT").⁴⁸ The supply of allowances comes from utilities with excess credits and from the CBOT itself.⁴⁹ The CBOT retains 2.8 percent of the total allowances allocated each year to ensure that utilities cannot monopolize the market and that parties who received no initial allocations can obtain them at a later date.⁵⁰ To date, SO₂ trading on the CBOT is the only national public exchange for pollution credits.⁵¹

The EPA and CBOT conducted the first annual auction of SO₂ emission allowances in 1993.⁵² The auction used sealed bids and sold both spot credits and advance allowances.⁵³ The first auction was not very active: "[P]rices were generally low, the offer/asking differential was substantial and relatively few utilities participated."⁵⁴

The March 1996 auction indicated market growth over the first three annual events. The CBOT auctioned 275,000 allowances, compared to 175,000 in 1995.⁵⁵ In 1996, the average success-

⁴⁵ 42 USC §§ 7651c, 7651d.

⁴⁶ 42 USC § 7651d.

⁴⁷ 42 USC § 7651b(a)(1).

⁴⁸ Deborah M. Mostaghel, *State Reactions to the Trading of Emissions Allowances under Title IV of the Clean Air Act Amendments of 1990*, 22 BC Envir Aff L Rev 201, 202 (1995). The CBOT sells the auctioned allowances on the basis of price, starting with the highest-priced bid. 42 USC § 7651o(d)(2).

⁴⁹ The EPA may not set a minimum price for the allowances withheld under § 7651o(b), but other sellers may specify a minimum sale price. 42 USC §§ 7651o(d)(2), (4).

⁵⁰ 42 USC § 7651o(b). For example, affected units in Phase I of the program that wish to expand their facilities will require additional allowances for the excess emissions generated by the expansion. The proceeds from sales of the withheld shares go to the individual utilities from whom they were initially withheld. 42 USC § 7651o(d)(3).

⁵¹ Lisa Heinzerling, *Selling Pollution, Forcing Democracy*, 14 Stan Envir L J 300, 303 (1995).

⁵² Adam J. Rosenberg, *Emissions Credit Futures Contracts on the Chicago Board of Trade: Regional and Rational Challenges to the Right to Pollute*, 13 Va Envir L J 501, 513 (1994).

⁵³ Id.

⁵⁴ Id at 516.

⁵⁵ Thomas Brozman, *Opening the Floor to Emissions Trading*, Chemical Marketing

ful bid price for an allowance was approximately \$68 per ton, down from \$132 per ton in 1995, and significantly less than the statutory price of \$1,500 per ton.⁵⁶ The number of bidders participating in the auction increased from 150 in 1995 to 263 in 1996.⁵⁷

Given the 1996 average bid price, achieving compliance by purchasing credits in the open market costs dramatically less than non-compliance, assuming full enforcement. The EPA fine for excess emissions of SO₂ is \$2,000 per ton.⁵⁸ Additionally, an excess polluter must offset its current year's excess emissions in the following year by a corresponding reduction in amount of tonnage produced.⁵⁹

Many auction participants agree that when most of the industry becomes subject to regulation during Phase II and firms have determined the extent of start-up costs,⁶⁰ the market will develop and mature effectively.⁶¹ This development is expected to result partly from increased price predictability and lower transaction costs. However, ERC trading will be cost-effective for firms only if they face differing marginal compliance costs.⁶² If they do, then the program will allow the utilities with lower marginal costs to reduce their own emissions and sell their ex-

Reporter SR8 (May 27, 1996).

⁵⁶ Id; 42 USC § 7651(c). The CBOT charges the statutory price for an allotment of 25,000-50,000 allowances from the 2.8% it withholds each year. The \$1,500 per ton sales price applies only to these particular allowances, which it sells on a first-come basis. 42 USC § 7651(c). Notwithstanding the statutory price, sales of privately-owned allowances can be sold at any price.

⁵⁷ Casey Bukro, *Cleaner Air at Lower Cost*, Chi Trib 3-1, 3-3 (Mar 26, 1996). The number of bidders exceeds the number of Phase I-regulated utilities because law schools, environmental groups, and other interested parties have bought and retired some credits to further limit the amount of SO₂ pollution. Brian Doherty, *Selling Air Pollution*, Reason 32, 35 (May 1996). Also, some Phase II-utilities are buying allowances and now banking them for use during Phase II. Bukro, *Cleaner Air at Lower Cost*, Chi Trib at 3-3 (cited in note 57).

⁵⁸ 42 USC § 7651j(a).

⁵⁹ 42 USC § 7651j(b).

⁶⁰ In order to lower emissions levels, utilities must either switch from high-sulfur to low-sulfur coal or install new technology, which is very expensive. With the former, utilities will realize cost-savings in the current year, but with the latter, the actual cost-savings will take place after the initial installation year. The evidence shows that many utilities have chosen to take the former route instead of making large capital expenditures because of uncertainty created by the pending deregulation of the electrical producer market. See *SO₂ Allowances' Sharp Price Decline Attributed Mainly to Low-Sulfur Coal*, 34 Air/Water Pollution Report's Envir Week 45, 45-46 (Jan 22, 1996).

⁶¹ Rosenberg, 13 Va Envir L J at 517 (cited in note 52).

⁶² Comment, *Assessing Point Source Discharge Permit Trading: Case Study in Controlling Selenium Discharges to the San Francisco Bay Estuary*, 21 Ecol L Q 79, 82 (1994).

cess allowances to utilities with higher marginal compliance costs. As long as purchasing a credit on the open market costs less than reducing actual emissions, a ready market for excess credits will exist. Of course, this scenario assumes moderate transactions costs and the accurate tracking of permits and emissions levels.⁶³

Several theories may help to explain why prices for SO₂ credits have been depressed since their introduction in 1990. First, the evidence shows that utilities have reduced emissions far past the Phase I targets.⁶⁴ Therefore, the supply of credits in the marketplace has greatly exceeded the demand. One critic has also suggested inadequacies in the bidding process and unwanted media scrutiny when utilities do engage in public trading contribute to low prices.⁶⁵

Perhaps one of the reasons that trading has not flourished as much as the EPA and Congress expected is that ERCs are not private property. In its 1990 amendments to the CAA, Congress specified that allowances to emit SO₂ do not constitute a property right and retained the right to terminate or withdraw them at anytime.⁶⁶ This characteristic may make firms wary of paying money for an uncertain future. Firms might hesitate to pollute during the year when uncertainty exists about whether they could purchase other firms' excess credits at the end of the year. Taking a more cautious route, many utilities have chosen to reduce emissions independently.⁶⁷ This hesitation may be a result of the uncertainty over the private property aspect of ERCs.

II. BANKRUPTCY LAW

A. Potentially Relevant Bankruptcy Code Provisions

Congress's decision not to give ERCs private property status also creates uncertainty about their treatment during bankruptcy. Generally, a bankruptcy estate includes all of the assets of the debtor, but Congress's characterization of ERCs might create an exception to this rule.

Determining whether to include ERCs in a bankruptcy estate and how to value them affects two situations. First, it determines

⁶³ Id.

⁶⁴ 34 Air/Water Pollution Report's Envir Week at 45 (cited in note 60).

⁶⁵ Doherty, *Selling Air Pollution*, Reason at 36-37 (cited in note 57).

⁶⁶ 42 USC § 7651b(f). See also Doherty, *Selling Air Pollution*, Reason at 36 (cited in note 57).

⁶⁷ Doherty, *Selling Air Pollution*, Reason at 35-36 (cited in note 57).

the availability of assets to satisfy the claims of creditors of a bankruptcy estate. Second, it affects the powers available to the trustee in voiding certain transfers and liens on the property of the debtor.

1. *'Property' of the bankruptcy estate.*

Bankruptcy protection should ensure an orderly liquidation process in the case of complete dissolution, or allow the debtor to reorganize its operations with some breathing space from its creditors.⁶⁸

Immediately after a debtor 'voluntarily' or its creditors 'involuntarily' file a petition for bankruptcy,⁶⁹ the Code creates an estate that includes "all legal or equitable interests of the debtor in property . . ."⁷⁰ This provision generally includes all assets of the debtor in the estate. For example, courts have held that causes of action,⁷¹ an FCC radio station operating license,⁷² an elevator maintenance contract,⁷³ and a motor carrier license⁷⁴ were property of an estate.

A restriction or condition on the transfer of a debtor's interest ordinarily will not exempt it from classification as property of the estate.⁷⁵ For example, the holder of an FCC broadcast license must receive approval from the FCC before transferring it to another party.⁷⁶ Nevertheless, at least one court has held that an FCC license is property of the bankruptcy estate.⁷⁷ Nor will the mere fact that an interest is government-created preclude the interest from classification as a property right.⁷⁸

⁶⁸ Douglas G. Baird and Thomas H. Jackson, *Cases, Problems, and Materials on Bankruptcy* 1-2, 37 (Little, Brown 2d ed 1990).

⁶⁹ Voluntary and involuntary petitions are classified as such from the perspective of the debtor. 11 USC §§ 301-303.

⁷⁰ 11 USC § 541(a).

⁷¹ *Sierra Switchboard Co. v Westinghouse Electric Corp.*, 789 F2d 705, 707-09 (9th Cir 1986).

⁷² *In re Central Arkansas Broadcasting Co.*, 68 F3d 213, 214-15 (8th Cir 1995).

⁷³ *In re Da-Sota Elevator Co.*, 939 F2d 654, 655-56 (8th Cir 1991).

⁷⁴ *Barutha v Prentice*, 189 F2d 29, 29-31 (7th Cir 1951) (holding that even though Wisconsin statute specifically did not confer property right to licensee, licenses were part of the bankruptcy estate because they were transferable and had considerable value).

⁷⁵ 11 USC § 541(c)(1). Restrictions on transfer of beneficial interest in a trust are also exempt. 11 USC § 541(c)(2).

⁷⁶ Communications Act, 47 USC § 301 (1994).

⁷⁷ *Central Arkansas Broadcasting*, 68 F3d at 214-15 ("Although federal regulations do not allow the debtor to own the broadcasting license, it still has considerable value to the debtor because the license can be transferred to a third party, subject to the FCC's approval.").

⁷⁸ *In the Matter of American Central Airlines, Inc.*, 52 Bankr 567, 570-71 (Bankr N D

In *In re Da-Sota Elevator Co.*,⁷⁹ the court held that an elevator maintenance contract was property of the bankruptcy estate.⁸⁰ The court based its decision on several factors, including the fact that the elevator maintenance contract had commercial value to the debtor and that it created "rights sufficiently similar to property rights to be treated as assets of a bankrupt estate."⁸¹ The court relied principally on *In re Nejberger*⁸² for the latter consideration.⁸³

Nejberger involved an expired liquor license which the court held to have value, despite its lapse, because reinstatement of the license was possible with a renewed application.⁸⁴ Looking to state law⁸⁵ to determine if a property right existed, the court held that "an expectation of consideration for renewal . . . qualifies as a property interest within the meaning of the Bankruptcy Act."⁸⁶

2. Effect of insolvency on the trustee's powers.

Insolvency is not a prerequisite to obtaining relief under the Bankruptcy Code's provisions. In both voluntary and involuntary petitions for bankruptcy, the debtor must simply be unable to meet its debts as they become due.⁸⁷ Instead, the issue of insolvency arises most often today in the context of the trustee's ability to avoid preferential transfers,⁸⁸ avoid fraudulent transfers and obligations,⁸⁹ and set aside liens on the debtor's property.⁹⁰

The Code creates a rebuttable presumption of insolvency during the ninety days preceding the filing of the bankruptcy petition.⁹¹ The voidable preference provisions of the Code work

Iowa 1985) (holding that a possessory interest in an airport landing slot constituted property of the estate).

⁷⁹ 939 F2d 654.

⁸⁰ Id at 655-56.

⁸¹ Id.

⁸² 934 F2d 1300 (3d Cir 1991).

⁸³ 939 F2d at 656.

⁸⁴ 934 F2d at 1301-03.

⁸⁵ Id at 1302. Although state law was not dispositive, the court found that it helped define 'property' of the estate, and that the ultimate classification was a matter of statutory interpretation of the Bankruptcy Code. Id at 1302, citing *Butner v United States*, 440 US 48 (1979).

⁸⁶ Id at 1303.

⁸⁷ 11 USC §§ 301, 303(h). See, for example, *In re Kjellsen*, 155 Bankr 1013, 1023 Bankr D SD 1993).

⁸⁸ 11 USC § 547(b)(3).

⁸⁹ 11 USC § 548(a)(2)(B)(i).

⁹⁰ 11 USC § 545(1)(D).

⁹¹ 11 USC § 547(f). See also Bankruptcy Reform Act of 1978, S Rep No 95-989, 95th

to ensure equality of distribution among all creditors and to deter creditors from racing to the courthouse to 'dismember' a debtor during its slide into bankruptcy.⁹² The court determines insolvency as of the time of the transaction in question, but may also use subsequent information.⁹³

The trustee may essentially reverse preferential transfers made by the insolvent debtor if they enabled a creditor to receive more than it would have had it participated in the distribution of the assets of the bankruptcy estate.⁹⁴ The trustee may also void fraudulent transfers or obligations incurred on or within one year before the date of the filing of the bankruptcy petition for which the debtor received less than "reasonably equivalent value" in exchange.⁹⁵ Finally, the trustee of a bankruptcy estate may void some liens on property of the estate that attempt to circumvent federal priorities.⁹⁶ These liens include those that first become effective against the debtor when the debtor becomes insolvent.⁹⁷

3. *Methods of valuation.*

The statutory definition of insolvency, which courts have dubbed the 'balance sheet test',⁹⁸ is a "financial condition such that the sum of such entity's debts is greater than all such entity's property, at fair valuation."⁹⁹ The statute does not define fair valuation of the bankruptcy estate, but courts have held that it should equitably reflect fair market price, such that "[i]t involves a value that can be made available for payment of debts within a reasonable period of time."¹⁰⁰ It is generally associated with the 'going concern' or 'fair market' value and might or might not be equivalent to the values assigned on the balance sheet prepared in accordance with Generally Accepted Accounting Principles ("GAAP").¹⁰¹ These values might not be equivalent be-

Cong, 2d Sess 89 (1978), reprinted in 1978 USCCAN 5875 (stating that the presumption is rebuttable).

⁹² Bankruptcy Law Revision, HR Rep No 95-595, 95th Cong, 2d Sess, 177-78 (1977), reprinted in 1978 USCCAN 6138; *Union Bank v Wolas*, 502 US 151, 161-62 (1991).

⁹³ *In re Mama D'Angelo, Inc.*, 55 F3d 552, 556 (10th Cir 1995).

⁹⁴ 11 USC § 547(b); HR Rep No 95-595 at 177, reprinted in 1978 USCCAN 6138 (cited in note 93).

⁹⁵ 11 USC § 548(a). See *BFP v Resolution Trust Corp.*, 511 US 531, 535-36 (1994).

⁹⁶ 11 USC § 545.

⁹⁷ 11 USC § 545(1)(D).

⁹⁸ See, for example, *In re R.M.L., Inc.*, 92 F3d 139, 154-55 (3d Cir 1996).

⁹⁹ 11 USC § 101(32)(A). The definitions applicable to partnerships and municipalities differ slightly from the general definition. 11 USC § 101(32)(B), (C).

¹⁰⁰ *Syracuse Engineering Co. v Haight*, 110 F2d 468, 471 (2d Cir 1940).

¹⁰¹ See *In the Matter of Lamar Haddox Contractor, Inc.*, 40 F3d 118, 121 (5th Cir

cause a GAAP balance sheet generally includes assets and liabilities valued on a historical basis.¹⁰² Fair value contemplates a willing seller and a willing buyer.¹⁰³ It estimates "what the debtor's assets would realize if sold in a prudent manner in current market conditions,"¹⁰⁴ ideally accounting for events that might affect ultimate realization.¹⁰⁵

Besides going concern or fair market value and GAAP, two other methods exist to value the assets of a bankruptcy estate. 'Liquidation value' is appropriate if the debtor is "so close to shutting its doors that a going concern standard is unrealistic."¹⁰⁶ A going concern is not necessarily a thriving business, but must be able to maintain some semblance of normal operations and have a reasonable ability to continue.¹⁰⁷ "Before the going concern valuation is to be abandoned the business must be wholly 'inoperative, defunct or dead on its feet'.¹⁰⁸ Alternatively, valuation may reflect the sale price at a 'fire-sale' auction.¹⁰⁹ As the name suggests, such a sale is one in which the immediate goal is to rid the estate of its assets at any price. The focus is on speed, rather than price.

B. The Treatment of ERCs in Bankruptcy¹¹⁰

No court appears to have addressed the issue of whether SO₂ reduction credits should be treated as assets in bankruptcy. Moreover, discussion among critics and academics is also lacking, probably because the credits are a relatively new phenomenon.

1994). But see *In re Craftmart, Inc.*, 1994 WL 118274, *4 (N D Cal 1994).

¹⁰² *In the Matter of Taxman Clothing Co., Inc.*, 905 F2d 166, 169-70 (7th Cir 1990).

¹⁰³ *Syracuse Engineering*, 110 F2d at 471.

¹⁰⁴ *Lamar Haddox Contractor*, 40 F3d at 121, quoting *Pembroke Development Corp v Commonwealth Savings & Loan Assn*, 124 Bankr 398, 401 (Bankr S D Fla 1991).

¹⁰⁵ *R.M.L.*, 92 F3d at 156.

¹⁰⁶ *Mama D'Angelo*, 55 F3d at 555-56, quoting *In re Vandais Lumber Supply, Inc.*, 100 Bankr 127, 131 (Bankr D Mass 1989).

¹⁰⁷ *Id* at 556; *Craftmart*, 1994 WL 118274 at *4.

¹⁰⁸ *In re Art Shirt Ltd., Inc.*, 93 Bankr 333, 341 (Bankr E D Pa 1988), quoting *In re Bellanca Aircraft Corp.*, 56 Bankr 339, 387 (Bankr D Minn 1985).

¹⁰⁹ See *Vanlecuwen v Farm Credit Administration*, 600 F Supp 1173, 1177, 1180 (D Or 1984). See also *In re EBP, Inc.*, 172 Bankr 241, 247 (Bankr N D Ohio 1994).

¹¹⁰ This Comment focuses on the federal SO₂ trading program for the sake of simplicity, but the reasoning extends to other emissions trading programs. This analysis is an adequate paradigm because the SO₂ program followed the general guidelines established by the EPA for all ERC trading, making it essentially a subset of the broader ERC trading program. In extending the reasoning, the valuation of the ERCs poses the only potential obstacle. Almost all ERC trades, other than SO₂ trades, are privately negotiated, leaving no public record of purchase price.

The CAA gives some guidance as to the implications of filing for bankruptcy on the ERC allocations. "[T]he removal of an existing affected unit or source from commercial operation at any time after November 15, 1990 . . . shall not terminate or otherwise affect the allocation of allowances pursuant to section 7651c [Phase I allocations] or 7651d [Phase II allocations] of [Title 42] to which the unit is entitled."¹¹¹ In other words, a change in the operation of any plant will not alter the amount of annual SO₂ emissions allowances it receives from the EPA.¹¹² The EPA would not return the credits to the general pool for reallocation to other utilities.

While the statute specifically addresses the consequences of a change in affected unit or source operations on ERC allocations, it is silent regarding the dissolution of an entire utility. Even so, the prediction that a utility will continue to receive its allocations while still a going concern would not conflict with the provision for individual affected units. In fact, the dissolution of an entire utility represents an aggregation of many changes in individual units. Presumably, however, if a utility then became completely inoperative, the total allocation in the remaining years of the program would decrease. This scenario, while somewhat speculative, is consistent with the CAA's broad goal of reducing the amount of air pollutants. This reading of the CAA suggests that ERCs are property, but only to the extent that an entity still exists to receive them.

III. PROPOSED TREATMENT OF ERCs

Although courts have yet to address the treatment of ERCs in bankruptcy, courts should include them as assets of a bankruptcy estate because they are similar to other permits and licenses that have been classified as assets. Moreover, this treatment would further the goals of the Bankruptcy Code. Furthermore, to achieve consistency with the Code, courts should use the fair market valuation method.

¹¹¹ 42 USC § 7651b(a).

¹¹² See Larry B. Parker, Robert D. Poling and John L. Moore, *Clean Air Act Allowance Trading*, 21 *Envir L* 2021, 2029 (1991) ("For example, a utility may choose to shut down an existing power plant and use those allowances to offset emissions from two newer, cleaner facilities.").

A. Proposed Treatment is Consistent with Case Law and Goals of the Bankruptcy Code

Because courts have construed the definition of 'property' of the bankruptcy estate broadly,¹¹³ the inclusion of SO₂ credits in the estate would be true to precedent. By including as many assets of the debtor in the estate as possible, the bankruptcy estate can simulate a going concern debtor dealing with its creditors. Also, because the estate is theoretically the 'remainder' of the debtor's operations, it should reasonably include all that the creditors helped to 'create' by extending credit to the debtor.

ERCs exhibit the relevant traits found in other assets that the courts have classified as property of the estate. As with FCC broadcast licenses, the state grants ERCs, conferring some right upon the holder.¹¹⁴ In the case of FCC licenses, the holder is entitled to broadcast radio waves on a particular band of the radio. An ERC entitles the holder to emit one ton of SO₂. However, the government does not allow the holder of either to 'own' the rights in the sense of retaining an absolute property right to them. FCC licenses are subject to redemption or seizure of the credits and Congress may withdraw or limit ERCs at any time.¹¹⁵ Nevertheless, courts have held that FCC licenses are property of the estate.¹¹⁶ By analogy, ERCs should also qualify as such.

At least one court, in contemplating an elevator maintenance contract, has answered the property question based on whether the asset has commercial value.¹¹⁷ Under this rule, courts should classify ERCs as property because the credits have an ascertainable commercial value. A filing for bankruptcy does not affect the initial allocations set forth in Title IV of the CAA.¹¹⁸ Therefore, the excess credits will still exist for a bankrupt utility or its trustee to sell for cash each year.

Likewise, courts have held both liquor licenses¹¹⁹ and motor carrier licenses¹²⁰ to be assets in a bankruptcy estate. Pollution credits are similar to these licenses because all are creatures of regulation and explicitly do not confer an absolute property right on the holder. The government may revoke or modify them at

¹¹³ See Part II.A.1.

¹¹⁴ Compare 47 USC § 301 (FCC) with 42 USC § 7651b (CAA).

¹¹⁵ Compare 47 USC §§ 501-04 (FCC) with 42 USC § 7651b(f) (CAA).

¹¹⁶ *In re Central Arkansas Broadcasting Co.*, 68 F3d 213, 214-15 (8th Cir 1995).

¹¹⁷ *In re Da-Sota Elevator Co.*, 939 F2d 654, 656 (8th Cir 1991).

¹¹⁸ See Part II.B.

¹¹⁹ *In re Nejberger*, 934 F2d 1300, 1301-03 (3d Cir 1991).

¹²⁰ *Barutha v Prentice*, 189 F2d 29, 31 (7th Cir 1951).

any time. Therefore, the classification of liquor and motor carrier licenses as assets of the estate should compel a similar classification of SO₂ credits.

The ultimate goal of the CAA is to reduce pollution. At first glance, excluding SO₂ credits from the bankruptcy estate would seem to further that goal. However, excluding the credits would not reduce the aggregate level of allowable emissions.¹²¹ Instead, exclusion would simply result in fewer available assets to satisfy creditors' claims.

The assets available to settle creditors' demands determine ex ante the extent to which they are willing to contract with a debtor and under what terms. During the normal course of business, the debtor enters into business arrangements with many parties, including suppliers, customers, and employees. These parties are interested in the financial stability of the debtor and the assets that will be available to the trustee to satisfy the claims in case of bankruptcy. If ERCs were available to the trustee to satisfy claims on the estate, then creditors would generally be more secure. In turn, they might agree to more lenient covenants, less security, or more favorable credit terms. These conditions would allow the debtor ex ante to engage in more business transactions, helping to increase economic growth.

A rule of inclusion would make parties more willing to deal with a debtor sliding into bankruptcy. Including SO₂ credits in the bankruptcy estate would increase the assets available under the 'balance sheet' test, thereby delaying statutory insolvency. This delay of insolvency might reduce the number of liens, preference payments, and fraudulent transfers which trustees could avoid, making creditors less wary about engaging in transactions with the debtor.

In general, creditors would be more likely to deal with the debtor ex ante and would receive more money on the dollar in bankruptcy ex post if SO₂ credits were included as assets of a bankruptcy estate. During times of distress, the inclusion of ERCs in the estate would result in a bigger pot for all creditors.

On the other hand, one can argue that it is irrelevant whether SO₂ credits are included as assets in the estate because once a legal rule is established, debtors and creditors will structure their behavior accordingly.¹²² Initial allocation does not matter

¹²¹ See Part II.B.

¹²² See generally Richard A. Posner, *Economic Analysis of the Law*, § 1.1 at 8 (Little, Brown 4th ed 1992).

to contracting parties because they can negotiate around any certain rule.¹²³ Nevertheless, the legal rule should be one that makes all parties better off than they would be under an alternative legal regime, while remaining consistent with the Code and the CAA. In the case of inclusion, creditors may expend less in monitoring costs because of a more credit-worthy debtor and the debtor may receive better credit terms and pledge less security. In addition, a rule of inclusion is more consistent with the broad reach of the Code's definition of property of the estate¹²⁴ and may induce all parties to rely more heavily on the use of ERCs.

B. Courts Should Use Fair Market Value to Value ERCs in Bankruptcy.

Courts have used fair market value to value other similar permits and licenses¹²⁵ and the Code contemplates this methodology.¹²⁶ Also, fair market value theoretically matches the amount ultimately realized upon sale of the credits. This amount is important because it conditions the trustee's avoidance powers on the estimated net worth of the estate after complete liquidation. The powers that the Code confers upon the trustee relating to transactions that occurred at the point in time of insolvency are powerful and must be limited to what Congress intended. The definition of insolvency specifies that the estimation process be at "fair valuation."¹²⁷

GAAP valuations, generally the lower of acquisition cost or market value, while relevant, do not control insolvency determinations: "Requiring application of GAAP would make accountants and the board which promulgate GAAP the arbiters of insolvency questions."¹²⁸ Acquisition cost might understate the value of the credits if acquired as part of an initial allocation under Title IV, because these allocations cost nothing to the recipient.¹²⁹ On the other hand, the GAAP valuation might equal the current fair market value if purchased in the open market, depending on when the transaction occurred. Because GAAP might understate or overstate the value of the credits, fair market value is a more

¹²³ Id.

¹²⁴ 11 USC § 541 (1994).

¹²⁵ See, for example, *Syracuse Engineering Co. v Haight*, 110 F2d 468, 471 (2d Cir 1940).

¹²⁶ See text accompanying notes 98-105.

¹²⁷ 11 USC § 101(32) (1994).

¹²⁸ *In re Sierra Steel, Inc.*, 96 Bankr 275, 278 (BAP 9th Cir 1989).

¹²⁹ 42 USC § 7651b(a)(1) (1994).

accurate and consistent method for assessing the value of the credits.

Compared to fair market value, valuation at both liquidation value and at 'fire sale' prices will tend to decrease the appraisal value of assets. The former contemplates the demise of the entity, which will necessarily incorporate a discount,¹³⁰ while the latter contemplates a hurried disposal of assets.¹³¹ In contrast, sales by the trustee in bankruptcy contemplate a more tempered approach, with negotiations between buyer and seller in an attempt to maximize net proceeds for the estate.¹³² Also, the trustee will continue to operate the business as usual until the net proceeds from sale may be maximized.¹³³ As such, both liquidation and fire sale valuations would tend to undervalue SO₂ credits. This too conflicts with the structure of the Bankruptcy Code.

CONCLUSION

Even though to date the courts and legal commentators have not addressed the issue of ERCs in a bankruptcy context, this relationship will inevitably become more important in the future. When that time comes, courts should consider the already established treatment of similar rights, such as broadcast and liquor licenses, in determining their treatment and valuation of such credits. By analogy to these other licenses, ERCs should also qualify as assets of the bankruptcy estate. Furthermore, courts should value ERCs at fair market value because this methodology is consistent with the purposes behind the Bankruptcy Code and the valuations of other licenses.

¹³⁰ See *In re Craftmart, Inc.*, 1994 WL 118274, *2 (N D Cal 1994).

¹³¹ See *Vanlecuwen v Farm Credit Administration*, 600 F Supp 1173, 1177, 1180 (D Or 1984).

¹³² See *Syracuse Engineering*, 110 F2d at 471.

¹³³ 11 USC §§ 721, 1106(a)(1) (1994).

